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INTERNATIONAL TRADE

Combating U.S. Competitors'
Tied Aid Practices

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INTERNATIONAL TRADE:
COMBATING U.S. COMPETITORS' TIED AID PRACTICES

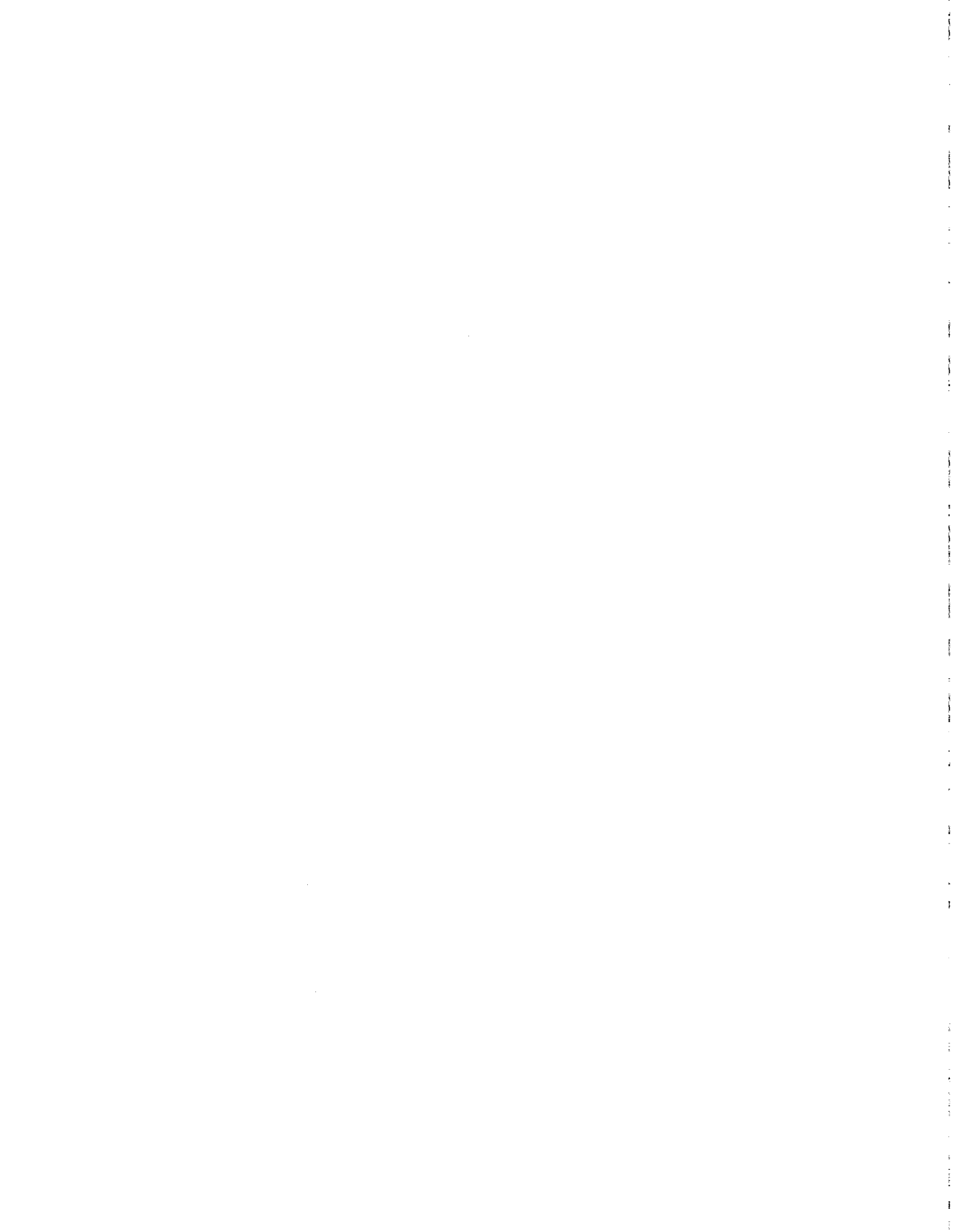
SUMMARY OF STATEMENT BY ALLAN I. MENDELOWITZ, MANAGING DIRECTOR
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Competitors' tied aid practices can put U.S. exporters at a competitive disadvantage in bidding on overseas projects. GAO estimated the potential loss of U.S. capital goods exports because of the tied aid practices of the U.S.' competitors in the Organization for Economic Cooperation and Development (OECD) to be as high as \$1.8 billion per year during 1989-91.

While the United States and its major competitors all provide tied aid, there is a significant difference between U.S. tied aid programs and those of its competitors: Most U.S. tied aid is devoted to programs geared toward "basic human needs" (education, health, and food aid), while other countries' tied aid programs focus on capital projects. Greater economic benefits to the donor country are generally thought to accrue from tying aid to capital projects than to basic human needs programs because capital projects usually involve importation of large amounts of high-value-added goods. Capital projects may also form the basis for follow-on sales in later years.

U.S. trade policy has generally been to oppose tied aid and, through international negotiations, dissuade the U.S.' competitors from using it. A 1992 OECD agreement, also called "the Helsinki agreement," strengthens previously established guidelines to discourage the use of trade-distorting tied aid. For 2 years following the implementation of the agreement (in February 1992), Eximbank policy was to use its "war chest" (a fund for responding to other countries' tied aid practices) only to enforce the 1992 agreement. Further, Eximbank officials believe that the decrease in notifications of tied aid offers over the past year is evidence that the agreement is effective. However, questions still exist about the effectiveness and enforceability of the agreement. Also, even if a competitor's tied aid offer conforms to the terms of the agreement, it may still hurt U.S. exporters and U.S. economic interests.

The administration has recently proposed establishing a \$150-million aid fund, called the "Tied Aid Capital Projects Fund," to finance major capital projects overseas as a way of combating other countries' tied aid use. While the Eximbank has implemented an aggressive policy toward tied aid through this fund, the amount would not be sufficient to offset lost U.S. capital goods exports if the adverse impact of competitors' tied aid is as high as \$1.8 billion per year. Also, the Eximbank has not established a process to identify new projects under consideration in developing countries and to find U.S. exporters to bid on these projects.



Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to testify before this Subcommittee on the issue of tied aid. My statement today summarizes the findings of our report on this subject that you released today, International Trade: Competitors' Tied Aid Practices Affect U.S. Exports.¹

"Tied aid" refers to foreign assistance that is linked to the purchase of exports from the country extending the assistance. Tied aid can consist of (1) foreign aid grants alone, (2) grants mixed with commercial financing or official export credits ("mixed credits"), or (3) concessional (low-interest-rate) loans.

Competitors' tied aid practices are of concern to the United States because U.S. exporters can be put at a competitive disadvantage in bidding on overseas projects when competitor countries make tied aid available.

In my testimony, I will discuss the following items: (1) our estimate of the adverse impact on U.S. exports of six major U.S. competitors' tied aid practices;² (2) our analysis of the differences between the U.S.' tied aid programs and those of our major competitors; (3) our review of U.S. policy toward tied aid; (4) our assessment of the Organization for Economic Cooperation and Development's (OECD)³ 1992 agreement on tied aid; and (5) our view of the Trade Promotion Coordinating Committee's (TPCC)⁴ new Tied Aid Capital Projects Fund.

ESTIMATE OF U.S. EXPORTS LOST TO FOREIGN COMPETITORS' TIED AID PRACTICES

We estimated that the potential loss of U.S. capital goods exports because of the tied aid practices of U.S. competitors in OECD was as high as \$1.8 billion per year during 1989-91. We arrived at this estimate using a methodology similar to that used by the U.S. Export-Import Bank (Eximbank) in its 1989 study, Report to the U.S. Congress on Tied Aid Credit Practices. The

¹International Trade: Competitors' Tied Aid Affects U.S. Exports (GAO/GGD-94-81, May 25, 1994).

²The six countries are Canada, France, Germany, Italy, Japan, and the United Kingdom.

³OECD is a forum for monitoring economic trends and coordinating economic policy among its 24 member countries, which include the economically developed, free-market democracies of North America, Western Europe, and the Pacific.

⁴TPCC is an interagency committee created by the President in 1990 to address the government's decentralized approach to export promotion.

Eximbank conducted a market share analysis using historical market share ratios based on 1984-87 data to estimate potentially lost U.S. exports. We updated this study using 1989-91 data. The market share analysis estimates additional U.S. capital goods exports that would have occurred if U.S. exporters had captured their historical market share of capital goods for all tied aid-supported projects.

We made two key assumptions in conducting this analysis. The first assumption was that recipient nations would have bought the same amount of capital goods with or without tied aid. The second assumption was that U.S. companies would have maintained their traditional market share in supplying capital goods to these nations.

To estimate the potential loss of U.S. capital goods exports, we conducted a market share analysis in four steps. We first determined how the amount of tied aid was divided among four different regions of the world. We then calculated the U.S. share (in both percent and dollars) of capital goods exports to each of these regions. Next, we multiplied the level of tied aid to each region by the U.S. share of all capital goods exported to the region. Summed over all the regions, this number represents the share of tied capital goods exports that reflects the relative competitive strength of the U.S. capital goods industries. Finally, to obtain our estimate, we subtracted the amount of U.S. capital goods exports supported by U.S. tied aid.

In doing our analysis, we found that two factors have opposite yet unquantifiable effects on the size of the estimate. The factor that could lead to an overestimate is the likelihood that some capital projects overseas would not have been undertaken in the absence of tied aid. On the other hand, a factor that may partially offset the tendency to overestimate potential lost U.S. capital goods exports is the fact that the U.S. market share in each region is likely to be smaller as a result of the effect of other countries' tied aid exports than it would have been without the presence of tied aid.

DIFFERENCE BETWEEN U.S. AND COMPETITORS' TIED AID PROGRAMS

The United States and its major competitors all provide tied aid. However, there is a major difference between U.S. tied aid programs and those of the six other countries we reviewed. While most U.S. tied aid is devoted to programs geared toward "basic human needs" (education, health, and food aid), other countries' tied aid programs focus on capital projects. Greater economic benefits to the donor country are generally thought to accrue from tying aid to capital projects than to basic human needs programs, because capital projects usually involve importation of large amounts of high-value-added goods. Capital projects may also form the basis for follow-on sales in later years.

On average, for 1988-91,⁵ the U.S. competitors in our review provided between 45 percent and 91 percent of their tied aid for capital projects, while the United States provided approximately 17 percent of its tied aid for capital projects. For example, during this 4-year period, an average of 91 percent of Germany's tied aid went to capital projects. France and Japan provided 73 and 76 percent, respectively.

U.S. POLICY HAS BEEN TO DISCOURAGE TIED AID BY SUPPORTING THE 1992 OECD AGREEMENT

As we have testified in 1993,⁶ U.S. trade policy has generally opposed tied aid and has sought, through international negotiations, to dissuade our competitors from using it. Since the early 1980s, the United States has negotiated a series of increasingly stronger versions of the "Arrangement on Guidelines for Officially Supported Export Credits" within OECD to restrict the use of trade-distorting tied aid. The 1992 agreement, sometimes referred to as "the Helsinki agreement," is the latest in the series and builds upon previously established guidelines contained in the earlier agreements. Twenty-two of the 24 members of OECD have signed the agreement to discourage the use of trade-distorting tied aid.⁷ The 1992 agreement is designed to (1) prohibit the use of tied aid for projects in countries whose per capita income was sufficiently high to make them ineligible for 17- or 20-year loans from the World Bank⁸; (2) restrict the use of tied aid for commercially viable projects (except for least-developed countries)⁹; and (3) increase transparency (openness) about tied aid use by strengthening notification and consultation procedures.

According to a Treasury official, under the terms of the 1992 agreement a participating member country planning to use tied aid must "notify" OECD. The agreement provides for a consultation process, during which other member countries may challenge the notifying country's tied aid offer if they believe it does not meet the agreement's guidelines. Once challenged, the initiating

⁵The most recent years for which OECD could provide tied aid data broken down by industry sector were 1988-91.

⁶See Export Finance: Challenges Facing the U.S. Export-Import Bank (GAO/T-GGD-94-46, Nov. 3, 1993).

⁷Although members of OECD, Iceland and Turkey have not signed the OECD's tied aid agreement.

⁸Examples of countries in this category are Argentina and Kuwait.

⁹Examples of least-developed countries are Afghanistan and Bangladesh.

country must justify to the member countries opposing the offer the use of tied aid on developmental grounds and show how the project does not meet the "commercial viability" test. A project is considered to be commercially viable if it is able to generate cash flow sufficient to cover the project's operating and capital costs or if it can be financed by the private market or official export credits.

If other countries are not satisfied with the justification, the offer may fail to win the substantial support of the member countries opposing the offer, in which case the donor may withdraw the offer. The donor country can, however, still decide to go forward with its offer, if it provides a "derogation letter" to the OECD Secretary-General, citing non-trade-related national interest reasons for opting not to follow the 1992 agreement guidelines.¹⁰

In 1992, there were 824 notifications¹¹ to OECD of tied aid credit offers. Those offers totaled approximately \$15.4 billion, although most were either "excludable"¹² or exempt from the consultation process because of grandfathering.¹³ The United States or other countries requested formal consultations on 41 of the 137 offers that were subject to the consultation process, primarily on the grounds of "commercial viability." Of 16 cases deemed commercially viable, the donor governments decided not to go forward with 9, and there were 7 derogations (i.e., the donor

¹⁰"Derogations" are cases in which the countries making the tied aid offers have proceeded with their offers, despite a decision by OECD agreement participants that the offers do not conform to the rules of the agreement.

¹¹"Notifications" represent tied aid offers reported to OECD, some of which never become commitments. Although notifications of offers are less precise than commitment data because they are reported in ranges, U.S. officials monitor notification of offers primarily to determine if any offers constitute potential trade distortions. Notification data are available through 1993, but actual commitment data are available only through 1990.

¹²Offers are excludable if they have a concessionality level of 80 percent or more or are under special drawing rights (SDR) 2 million, constitute matches of other tied aid offers, are directed toward least-developed countries, or are for ships. An SDR is an official international monetary reserve asset created by the International Monetary Fund. One SDR currently is equal to about \$1.39.

¹³"Grandfathering" refers to a provision included in a new rule that exempts from the rule a person or business already engaged in the activity coming under regulation.

governments have proceeded with their offers). During 1993, there were two additional derogations.

Eximbank Has Used the War Chest Selectively to Enforce the 1992 OECD Tied Aid Agreement

For 2 years following the implementation of the most recent OECD agreement in February 1992, Eximbank policy has been to use its "war chest"¹⁴ to enforce the agreement (i.e., to match other countries' offers in cases where tied aid did not conform to the agreement--particularly where consultations did not result in the withdrawal of a tied aid offer considered to be inconsistent with the agreement). Although there have been nine derogations from the agreement since it went into effect, the Eximbank has made only one matching tied aid offer in that time period.

The Eximbank's mechanism for using the war chest has been described as "demand driven," i.e., the Eximbank generally only responded to requests from U.S. exporters. The mechanism did not provide for identifying competitors' tied aid offers and then seeking out U.S. exporters to compete with these offers. According to the Eximbank, the list of tied aid notifications from OECD is considered confidential. This confidentiality inhibits the Eximbank's ability to "reach out to exporters." Moreover, funds used for war chest purposes are "expensive" because they have higher concessionality levels and do not support as much in U.S. exports, per dollar, as non-war-chest loans or guarantees do.

ASSESSMENT OF THE 1992 OECD AGREEMENT'S LIMITATIONS

While considered by some U.S. officials as an improvement over previous agreements, the 1992 agreement does have some built-in limitations. These limitations include (1) the difficulty of defining "commercially viable"; and (2) the presence of an "escape clause" that allows countries to proceed with a tied aid offer, despite objections by other participants, if that country claims that the project is in its national interest. Also, there are questions about the enforceability of the agreement because participation is voluntary and data needed to monitor compliance are not confirmed or verified. Furthermore, the European Union (formerly referred to as the European Community) is not subject to the agreement's tied aid rules. Although individual members of the European Union are required to report bilateral tied aid to OECD and are subject to its tied aid rules, the agreement specifically excludes "aid programs of multilateral or regional institutions." Thus, tied aid offered by the European Union itself is considered by the European Union to be--and reported to

¹⁴In 1986, Congress authorized the Eximbank to create a "war chest" fund to counter the use of tied aid credits by other countries.

OECD as--multilateral aid: It cannot officially be challenged within the consultation process. Some U.S. officials have suggested that European Union members might be using their multilateral European Union tied aid instead of bilateral tied aid to circumvent the rules of the agreement. The Eximbank has recently provided tied aid funds to match a European Union tied aid offer that is permissible under the rules of the agreement. Also, OECD members are considering whether European Union tied aid should be subject to tied aid rules.

Despite these limitations, some U.S. officials believe that the 1992 agreement has been more effective in reducing tied aid than past agreements were. They cite as evidence the fact that notifications to OECD of tied aid offers decreased significantly in 1993. Total tied aid notifications for 1993 were \$7 billion, compared to \$15.4 billion in 1992. According to the Eximbank, the decrease in tied aid offers is due to (1) the impact of the 1992 agreement, (2) the presence of budgetary constraints in the donor countries, and (3) the shift from tied to untied aid.¹⁵ Notifications to OECD of untied aid offers have increased dramatically since the new tied aid rules went into effect, and there are concerns that one or two countries are simply reporting tied aid as untied aid to circumvent the rules. U.S. officials said they are closely monitoring untied aid notifications, and OECD is reviewing how member countries report their untied aid.

EXIMBANK IMPLEMENTATION OF THE TPCC'S CAPITAL PROJECTS FUND

In February 1994, the administration announced its new policy for responding to competitors' tied aid practices; it proposed a new \$150-million aid fund, called the "Tied Aid Capital Projects Fund," to finance major capital projects overseas. The \$150 million represents the subsidy component of the fund, which could potentially support (under credit reform)¹⁶ \$600 million in U.S. exports. The stated purpose of the Tied Aid Capital Projects Fund is to combat other countries' use of tied aid. The Eximbank has been given the task of administering the fund, \$50 million of which is to come from the Eximbank's war chest. The remaining \$100 million is expected to come from "proportional contributions" from the export promotion budgets of other TPCC agencies. In addition, the Eximbank has \$121 million in "carryover" from prior years' war chest budgets that can be used

¹⁵See the Eximbank's Report to the Congress Under Section 15(g) of the Export-Import Bank Act of 1945, as Amended (Washington, D.C.: Dec. 9, 1993).

¹⁶Under the Federal Credit Reform Act of 1990, the estimated total future costs of the Eximbank's annual transactions must be accounted for when the transactions are made, and these costs are limited by the total amount appropriated for that activity.

in any year.

The new fund constitutes an increase over funds that have been available for such tied aid in previous years. However, the total amount in the fund is still relatively small compared to U.S. funds devoted to counter foreign countries' agricultural export subsidies (\$532 million proposed for fiscal year 1995). Further, the amount of the new fund is not sufficient to counter our estimate of up to \$1.8 billion in potential U.S. capital goods export losses in past years resulting from competitors' tied aid practices. Using the same ratio implied by the estimate that \$150 million in the Capital Projects Fund would support \$600 million in exports, the United States would have to provide a subsidy equaling \$450 million per year in order to counter tied aid capital goods export losses of \$1.8 billion.

Since we completed our review, the Eximbank has implemented a stronger policy toward tied aid through the Tied Aid Capital Projects Fund than that used with the war chest. The Eximbank's new "letter of interest" policy will permit a U.S. exporter to compete for projects as soon as a competitor is strongly suspected of offering trade-distorting tied aid. The letter of interest should provide U.S. exporters with greater assurance that the Eximbank is willing to aggressively match competitors' use of trade-distorting tied aid. Previously, exporters had to wait until the notification and consultation process had been completed and a derogation had occurred. This was often too late for a U.S. firm to bid on a project.

However, some U.S. government officials and U.S. exporters are still concerned about whether export promotion agencies are identifying capital projects early enough for U.S. exporters to have an opportunity to bid successfully on them. While we recognize the Eximbank's new policy to aggressively use the Capital Projects Fund as a positive step toward countering competitors' use of tied aid, it does not provide the Eximbank with a mechanism to identify competitors' tied aid offers and to find U.S. exporters to respond to these offers.

CONCLUSIONS

The U.S.' tied aid strategy has had some success--U.S. officials have negotiated to establish successively stronger international agreements to restrict trade-distorting tied aid. However, the Eximbank's prior policy of using its war chest primarily to enforce the 1992 OECD tied aid agreement meant that many U.S. firms could not access tied aid funds to combat competitors' use of tied aid that were in conformity with the 1992 agreement but that nevertheless harmed U.S. long-term interests. Further, because the Eximbank's approach was reactive, no process was established to identify capital projects in developing countries early enough for U.S. exporters to bid on them.

Based on the results of our review, we believe that a credible U.S. policy to combat competitors' trade-distorting tied aid practices should include (1) assurances by U.S. government agencies that the U.S. government has an active policy to counter competitors' tied aid offers and (2) sufficient funds to counter competitors' tied aid offers. Once these two elements of a credible policy are in place, U.S. firms may be more likely to compete for the capital projects early on.

We recognize that the Eximbank and TPCC have taken steps toward making the U.S.' tied aid policy more credible. The Eximbank's new policy suggests that U.S. exporters will be able to count on tied aid funds for matching competitors' tied aid offers much more readily, and for a broader range of situations, than before. Also, with the introduction of the new Tied Aid Capital Projects Fund TPCC has increased the amount of tied aid funds available to support U.S. exporters. However, the funds are still not sufficient to counter estimates of past U.S. export losses (as high as \$1.8 billion per year).

While the 1992 OECD agreement may reduce U.S. exports lost to tied aid and the size of a fund needed to counter tied aid, it is too early to determine the ultimate result of the agreement. The agreement will have to be closely monitored for several years. During this period, having a sufficiently large commitment to counter competitors' tied aid would strengthen the U.S. ability to enforce the agreement. If the agreement succeeds in genuinely reducing competitors' tied aid, it may not be necessary to expend as much as \$450 million per year from a capital projects fund. However, having the authority to expend a sufficient amount to be credible is important.

RECOMMENDATION

In order to provide greater assurance to U.S. exporters that the U.S. government is serious about combating foreign competitors' tied aid practices, we are recommending in our report that the Secretary of Commerce, as chair of TPCC, work with other member agencies to ensure that the budget for the Tied Aid Capital Projects Fund is sufficient to counter competitors' trade-distorting tied aid offers when U.S. economic interests are adversely affected.

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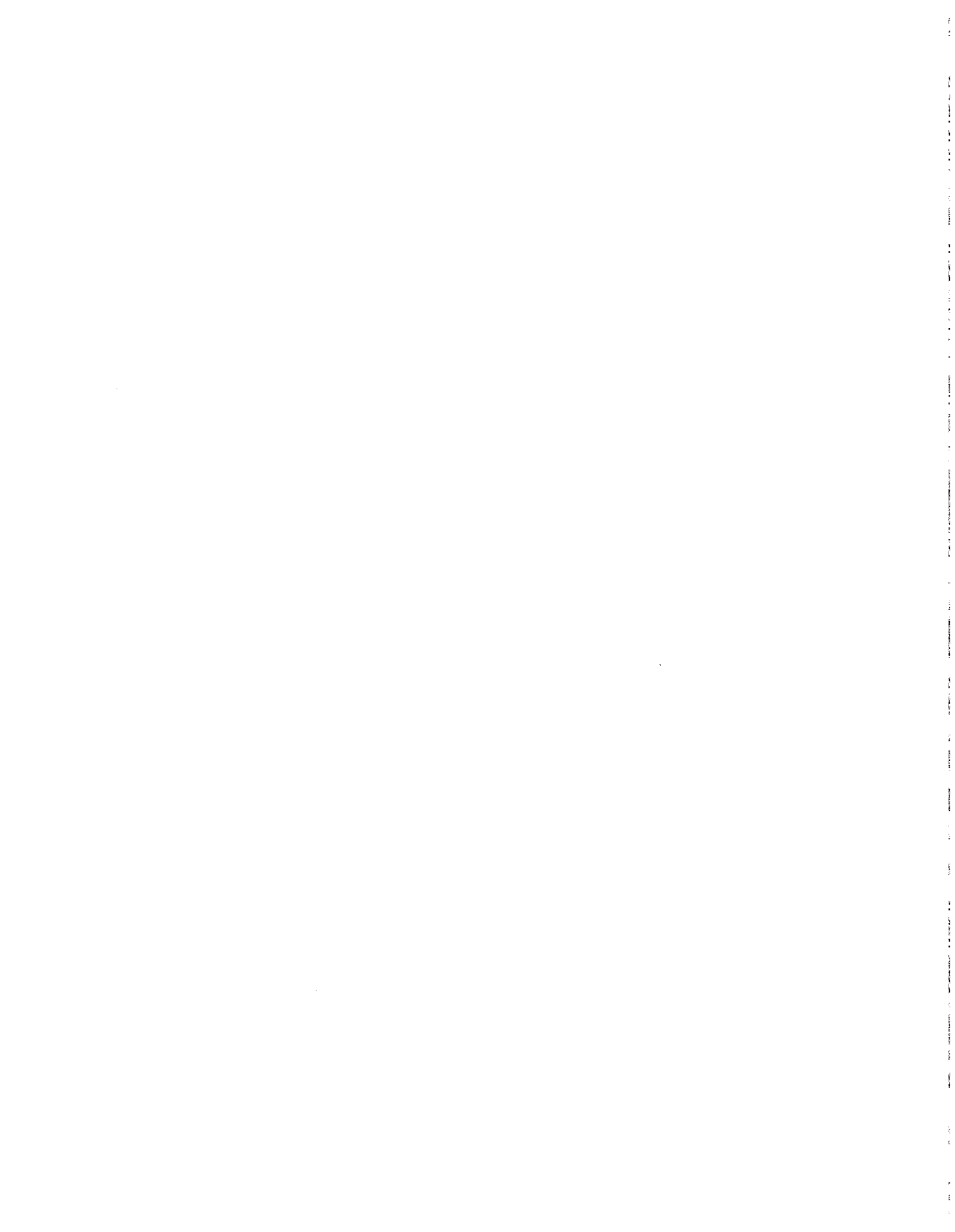
Mr. Chairman, this concludes my prepared statement. I will be happy to try to answer any questions you or other Members of the Subcommittee may have.

RELATED GAO PRODUCTS

International Trade: Competitor's Tied Aid Practices Affect U.S. Exports (GAO/GGD-94-81, May 25, 1994).

Export Finance: Challenges Facing the Export-Import Bank (GAO/T-GGD-94-46, Nov. 3, 1993).

Export Finance: The Role of the U.S. Export-Import Bank (GAO/GGD-93-39, Dec. 23, 1992).



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